

DIRECT TESTIMONY

OF

ERIC LOUNSBERRY

ENERGY ENGINEERING PROGRAM

SAFETY AND RELIABILITY DIVISION

ILLINOIS COMMERCE COMMISSION

CONSUMERS GAS COMPANY

DOCKET NO. 07-0570

April 3, 2012

1 Q. Please state your name and business address.

2 A. My name is Eric Lounsberry, and my business address is 527 East Capitol
3 Avenue, Springfield, Illinois 62701.

4 Q. By whom are you employed and in what capacity?

5 A. I am employed by the Illinois Commerce Commission ("Commission") as a
6 Supervisor of the Gas Section of the Energy Engineering Program of the Safety
7 and Reliability Division.

8 Q. Please state your educational background and work experience.

9 A. I received a Bachelor of Science degree in Civil Engineering from the University
10 of Illinois and a Master of Business Administration degree from Sangamon State
11 University (now known as University of Illinois at Springfield).

12 Q. What are your primary responsibilities and duties as the Supervisor of the Gas
13 Section of the Safety and Reliability Division's Energy Engineering Program?

14 A. I assign my employees or myself to cases, provide training, and review work
15 products over the various areas of responsibility covered by the Gas Section. In
16 particular, the responsibilities and duties of Gas Section employees include
17 performing studies and analyses dealing with day-to-day and long term,
18 operations and planning for the gas utilities serving Illinois. For example, Gas
19 Section employees review purchased gas adjustment clause reconciliations, rate
20 base additions, levels of natural gas used for working capital, and utility

21 applications for Certificates of Public Convenience and Necessity. They also
22 perform audits of utility gas meter shops.

23 Q. What is the purpose of this proceeding?

24 A. On November 28, 2007, the Commission initiated its annual reconciliation of the
25 Purchased Gas Adjustment ("PGA") for calendar year 2007, as filed by
26 Consumers Gas Company ("Consumers" or "Company"), pursuant to
27 Section 9-220 of the Illinois Public Utilities Act (the "Act"). The Commission
28 initiated this investigation to determine whether Consumers' PGA clause reflects
29 actual costs of gas and gas transportation for the twelve-month period from
30 January 1, 2007 through December 31, 2007, and whether those purchases
31 were prudent.

32 Q. What is your assignment in this proceeding?

33 A. My assignment is to determine if Consumers' natural gas purchasing decisions
34 made during the reconciliation period were prudent. I also provide background
35 information related to my understanding about the various agreements that have
36 historically existed and those that existed during the reconciliation period
37 between Consumers and its affiliate, Egyptian Gas Storage Corporation
38 ("Egyptian").

39 Q. Have you made a determination as to whether Consumers' natural
40 gas purchasing decisions were prudent?

41 A. Yes. Using the Commission's criteria for prudence, I find no reason to dispute
42 the Company's assertion that all gas supply purchases were prudently incurred
43 during the reconciliation period, except for the transactions between Consumers
44 and its affiliate Egyptian where Consumers hedged its winter gas supply.

45 Q. What criteria does the Commission use to determine prudence?

46 A. The Commission has defined prudence as:

47 [...] that standard of care which a reasonable person would be
48 expected to exercise under the circumstances encountered by
49 utility management at the time decisions had to be made. In
50 determining whether a judgment was prudently made, only those
51 facts available at the time the judgment was exercised can be
52 considered. Hindsight review is impermissible.

53 Imprudence cannot be sustained by substituting one's judgment for
54 that of another. The prudence standard recognizes that
55 reasonable persons can have honest differences of opinion without
56 one or the other necessarily being 'imprudent'. (Docket No. 84-
57 0395, Order dated October 7, 1987, page 17)

58 Q. What material did you review to determine the prudence of Consumers' natural
59 gas purchasing decisions during the reconciliation period?

60 A. I reviewed the direct testimony of Company witness J. Glenn Robinson. I also
61 reviewed Company responses to numerous Staff data requests ("DR") that
62 directly addressed issues related to the prudence of Consumers' natural gas
63 purchasing.

64 Q. What recommendations are you making in this proceeding?

65 A. My review found the hedging transactions between Consumers and its affiliate
66 Egyptian imprudent because Consumers lacked the appropriate Commission
67 approval to enter into those transactions.

68 I conclude that the original purpose of the Gas Sales Agreement (“GSA”)
69 between Consumers and Egyptian was for the purchase of local gas production.
70 Further, I determined that at no time was a hedging transaction discussed or
71 considered with regard to the GSA.

72 My review also found that an inherent conflict of interest exists in transactions
73 between regulated Consumers and its unregulated affiliate Egyptian since
74 Mr. C. A. Robinson was the President and CEO of both Companies at the time
75 Consumers entered into the hedging transactions.

76 Q. What do you mean by hedging transactions?

77 A. Hedging is any transaction that is designed to lower price risk. Price risk is the
78 uncertainty about whether the price changes. For this proceeding, I discuss the
79 hedging transactions involving Consumers agreeing to purchase a set volume of
80 natural gas in advance of the period during which Egyptian would deliver the gas.

81 Q. Do you have any schedules attached to your testimony?

82 A. No.

83 **Hedging Transaction Summary**

84 Q. Did Consumers take part in a hedging transaction with its affiliate Egyptian
85 during the reconciliation period?

86 A. Yes. Mr. J. Glenn Robinson in his direct testimony, page 4, indicates that in May
87 2006 Consumers signed a contract with its affiliate Egyptian for delivery of
88 77,000 dekatherms (“DTH”) for delivery in the months of January, February, and
89 March 2007.

90 Q. Did Consumers notify the Commission in 2006 that it intended to enter into
91 hedging transactions with its affiliate Egyptian?

92 A. No. In response to Staff DR ENG 1.72 from Docket No. 06-0744, Consumers
93 stated it did not notify the Commission of its intention to enter into hedging
94 transactions with its affiliate Egyptian.

95 Q. Do you believe the Commission’s rules governing affiliate transaction required
96 Consumers to notify the Commission of its intention to hedge gas supplies with
97 its affiliate Egyptian?

98 A. Yes. I am not an attorney, but my understanding of Section 7-101 of the Act is
99 that it requires Consumers to notify and to obtain approval of the Commission
100 before conducting business with its affiliate Egyptian.

101 Q. Did Consumers provide any rationale for what authority it used to perform
102 hedging transactions with its affiliate Egyptian pursuant to Commission
103 regulations?

104 A. In response to Staff DR ENG 1.61 from Docket No. 06-0744, Consumers stated
105 at the time of the transaction it had a contract with its affiliate Egyptian, known as
106 the Gas Sales Agreement (“GSA”), to purchase gas.

107 Q. Do you agree that Consumers’ GSA provided it with the authority to conduct the
108 hedging transactions you discuss above?

109 A. No. As I will discuss in more detail below, I do not consider the GSA as
110 providing Consumers with the authority to enter into a hedging transaction with
111 its affiliate Egyptian.

112 Q. Did Consumers utilize a request for proposals to solicit competitive bids for
113 hedging its 2006/2007 winter gas supply?

114 A. No. In response to Staff DR ENG 1.61 in Docket No. 06-0744, Consumers
115 stated that it made no direct requests to other gas suppliers, and it considered
116 no other proposals. Consumers hedged its 2006/2007 winter gas supply with its
117 affiliate Egyptian without recourse to any market and without regard to whether
118 the hedging could be accomplished cheaper somewhere else.

119 Q. Were the hedging transactions that Consumers executed with its affiliate
120 Egyptian in 2006 for its 2006/2007 winter gas supply prudent?

121 A. No. I found Consumers' hedging transactions with its affiliate Egyptian
122 imprudent because the transactions were performed without Commission
123 authority and without competitive bids. Staff witness Rearden, ICC Staff Exhibit
124 3.0, also finds Consumers' hedging transactions with its affiliate Egyptian
125 imprudent. Dr. Rearden's testimony provides further rationale as well as
126 calculates an imprudence disallowance.

127 **Prior Cases**

128 Q. Has the Commission addressed Consumers' decision to enter into a hedging
129 transaction with its affiliate Egyptian in the past?

130 A. Yes. In Docket No. 06-0744, Consumers' 2006 PGA proceeding, Staff testified
131 that Consumers was imprudent for entering into a hedging transaction with its
132 affiliate. The Commission agreed. The Commission's Order, in part, concluded
133 the following:

134 The Commission has reviewed the evidence presented and the
135 arguments of the parties, and is of the opinion that the evidence
136 shows that the gas purchases by Consumers in question were not
137 entered into prudently, and that Staff has properly calculated the
138 appropriate adjustment. The Commission notes that it closely
139 scrutinizes situations such as that presented here, where a party
140 has the opportunity to represent both a regulated utility and un-
141 regulated entity, as the risk of ratepayers subsidizing the un-
142 regulated entity are inherently present.

143 Staff correctly points out that as Mr. Robinson is the decision
144 maker for both Consumers and Egyptian, any transaction between
145 the two necessarily requires close scrutiny due to the potential for
146 Egyptian to profit on the transaction. The Commission finds that
147 the course of dealings between Consumers and Egyptian shows a
148 pattern of behavior that consistently results in Consumer's

149 ratepayers incurring a higher cost of gas than should have occurred
150 had the purchases been pursued in a prudent manner. As reflected
151 in the evidence, the portion of Egyptian's sales that came from
152 Consumers was steadily increasing, until in 2006, Consumers was
153 apparently the only entity providing payments to Egyptian, which
154 provided Egyptian the opportunity to maximize profits at
155 Consumer's ratepayers expense. The evidence detailed by Staff
156 shows a consistent pattern of transactions in which the intent was
157 more to maximize the profit to Egyptian than to ensure that the
158 customers of Consumers received gas at a fair and prudent price.

159 While Consumers argues that there was a GSA in place between
160 Consumers and Egyptian which allowed the course of conduct in
161 which Consumers engaged in 2006, the Commission suggests that
162 the actions taken by Mr. Robinson went beyond what was
163 authorized in the GSA. The Commission further notes that renewal
164 of the GSA was considered by the Commission in Docket No. 08-
165 0139, and the Commission rejected Consumer's GSA as not in the
166 public interest. While the GSA was admittedly in effect during the
167 time period in question in this proceeding, the actions taken by Mr.
168 Robinson on behalf of Consumers and Egyptian appear to have
169 stretched beyond recognition the actions allowed under the GSA.
170 (Order, Docket No. 06-0744, pp. 23-24, April 12, 2011)

171 Q. Do the hedging transactions at issue in this proceeding differ from the hedging
172 transaction at issue in Docket No. 06-0744?

173 A. No. The hedging transactions at issue in Consumers' 2006 and 2007 PGA
174 proceeding are related in that they were entered into under the same
175 circumstances, at approximately the same time, and involved the delivery of gas
176 for Consumers' customers in the 2006/2007 winter season.

177 Q. Aside from the hedging transaction, has the Commission discussed other
178 transactions between Consumers and its affiliate Egyptian in the past?

179 A. Yes. In its Order dated February 3, 2009, in Docket 05-0741 (Consumers' 2005
180 PGA), page 6, IV Findings and Ordering Paragraphs, (7), the Commission
181 stated:

182 Consumers Gas Company shall cease any sale for resale
183 transactions involving the Gas Sales Agreement with Egyptian Gas
184 Storage Corporation until further order of the Commission.

185 In Docket No. 08-0139, Consumers attempted to get Commission approval to
186 renew the GSA. The Commission rejected Consumers request and stated in its
187 Order dated, August 18, 2010, page 18, in part, that:

188 Staff provides sufficient reason for the Commission to determine
189 that approving the Gas Sales Agreement would not be in the public
190 interest. Consistent with the conclusions in the Order in Docket No.
191 05-0741, the Commission again questions the sincerity of
192 Mr. Robinson's testimony and his motivations.

193 **Background**

194 Q. What agreements did Consumers have with Egyptian that relate to Consumers'
195 supply of natural gas when it decided to enter into the hedging transaction?

196 A. In 2006, when Consumers entered into the hedging transactions with Egyptian, it
197 had two contracts with Egyptian, the GSA and a Gas Storage Contract.

198 Q. Did the Commission approve these agreements between Consumers and
199 Egyptian?

200 A. Yes. The Commission approved the contracts in Docket No. 03-0349, in an
201 Order dated September 22, 2003. The Commission approved the precursor

202 agreements in Docket Nos. 97-0338/97-0339 (Cons.) in an Order dated May 6,
203 1998.

204 Q. Were you assigned to either of the cases wherein the Commission approved the
205 agreements between Consumers and Egyptian?

206 A. Yes. I was the Engineering witness assigned to both the 2003 as well as the
207 1997 proceedings.

208 Q. Are you discussing both agreements in this testimony?

209 A. No. My discussions below are limited to Consumers' use of the GSA.

210 Q. What is local gas?

211 A. Local gas refers to any natural gas that is produced by wells in Illinois including
212 gas production from landfills.

213 Q. Does the Commission have any rules or regulations governing the purchase of
214 local gas?

215 A. Yes. The Commission's rules regarding local gas purchases are found in 83
216 Illinois Administrative Code 530 ("Part 530"), Safety and Quality Standards for
217 Gas Transportation for a Private Energy Entity by Gas Utilities. The
218 Commission's authority for Part 530 comes from the Gas Transmission Facilities
219 Act ("GTFA"), 220 ILCS 25 (previously Ill. Rev. Stat. 111 2/3 para. 570).

220 Q. Please summarize what is contained in Part 530.

221 A. Part 530 contains the quality requirements for any local gas purchased by a
222 public utility, and sets forth the delivery requirements and the legal rights of the
223 parties.

224 Q. Does Part 530 require utilities to purchase local gas?

225 A. No. However, Part 530 does require the utility to transport local gas. Since Part
226 530 requires utilities to transport local gas, the utility normally also purchases the
227 gas (at a price slightly below market), if the utility can make use of it and the gas
228 meets the quality specifications. Further, since local gas is priced below market
229 price, the utility can exhibit prudent behavior by acquiring the lowest cost gas
230 supply for its customers when it buys local gas.

231 Q. Does the GTFA contain language relevant to the instant proceeding?

232 A. Yes. Section 1.03 of the GTFA states, in part, that:

233 "Private energy entity" includes every person, corporation, political
234 subdivision and public agency of the State who generates or produces
235 natural gas for energy for his or its own consumption or the consumption
236 of his or its tenants or for direct sale to others, excluding sales for resale,
237 and every person, corporation, political subdivision and public agency of
238 the State who buys natural gas at the wellhead for his or its own
239 consumption or the consumption of his or its tenants and not for sale to
240 others. (emphasis added)

241 Further, Section 3 states, in part, that:

242 Upon application of a private energy entity, and after notice to any
243 affected public utility and opportunity for hearing thereon, the Commission
244 shall authorize such entity to construct an interconnection for the purpose
245 of transporting natural gas for the private energy entity, if the Commission
246 finds:

- 247 (a) that such interconnection is in the public interest and for the
248 general public benefit;
- 249 (b) that the interconnection involves natural gas produced within
250 this State in the service area of the public utility, ultimately
251 consumed within this State, and which would otherwise be
252 undeveloped because a public utility is unable or unwilling to
253 purchase it at a price the Commission finds to be
254 reasonable; (emphasis added)

255 Q. What is your non-legal understanding of the phrase “sales for resale” as it is
256 used in the GTFA?

257 A. My understanding of “sales for resale” as used in the GTFA refers to selling local
258 gas to a broker that then sells it to another entity. Under that situation the broker
259 does not qualify as a “private energy entity” as defined above.

260 Q. In your non-legal opinion, does an entity who purchases gas from a non-local
261 source and resells that gas as local production qualify as a “private energy
262 entity?”

263 A. No.

264 **Gas Sales Agreement**

265 Q. What is your understanding of the purpose of the GSA between Consumers and
266 Egyptian?

267 A. My understanding is that the GSA sets forth the terms under which Consumers
268 may purchase local gas from Egyptian.

269 Q. What is the basis for your statement that the GSA between Consumers and
270 Egyptian involves the purchase of local gas?

271 A. In the original proceeding that approved the GSA between Consumers and
272 Egyptian (Docket Nos. 97-0338/97-0339 (Cons.)), Consumers was asked in Staff
273 data request EGE 1.1 whether the gas purchased pursuant to the GSA would
274 always be priced less expensively than gas purchased pursuant to the
275 Company's other gas supply agreements. The Company's response indicated
276 that: "Local gas would always be 5¢ less than any other gas purchased. This is
277 because Consumers offers to pay less for local gas. However, the price in
278 sufficient to attract gas producers to drill along our system."(sic)

279 Q. In your experience, is a 5¢ reduction in the gas price from the market price a
280 common method for a gas utility to purchase local gas?

281 A. Yes.

282 Q. Is there any evidence in the record in Docket Nos. 97-0338/97-0339 (Cons.) that
283 the Company would use the GSA to purchase any gas other than local gas
284 production?

285 A. No.

286 Q. Has the Company commented on the GSA's purpose?

287 A. Yes. Mr. C.A. Robinson in his rebuttal testimony in Docket No. 08-0139 (CAR-
288 2.0, p. 4) agreed that the original purpose of the GSA was to allow the purchase
289 of local gas.

290 Q. What changes, if any, did the Company make to the GSA that the Commission
291 approved in Docket Nos. 97-0338/97-0339 (Cons.) versus the GSA the
292 Commission approved in Docket No. 03-0349?

293 A. My review of the two agreements showed very minimal changes exist between
294 the two documents, with two exceptions. First, under Article IV – Price, Section
295 4.1, the 2003 agreement was altered to simplify the language that discussed the
296 price assigned to gas purchased by Consumers from Egyptian, but retained the
297 5¢ below-market language. The second change was to Article VII – Quality,
298 Section 7.1, in that the 2003 agreement added language that specifically
299 referenced the gas quality requirements of Part 530.

300 Q. Is there any evidence in the record in Docket No. 03-0349 that Consumers
301 contemplated purchasing any non-local gas via the GSA?

302 A. No. Further, Consumers added a reference to Part 530 in the GSA agreement.
303 In my mind, that strongly suggests that the purpose of the GSA was limited to the
304 purchase of local gas.

305 Q. Does the Company agree that the purpose of the 2003 GSA was limited to the
306 purchase of only local gas?

307 A. No. The Company stated that the 2003 GSA does not specifically mention local
308 gas. Further, Mr. C.A. Robinson, in his rebuttal testimony in Docket No. 08-0139
309 (CAR-2.0, p. 4), argued that the purpose of the GSA changed in the time
310 between the agreement the Commission approved in the 1997 proceeding and
311 the 2003 agreement that was in force during 2007.

312 Q. Do you agree with Mr. Robinson's statements?

313 A. No. While the GSA approved in the 2003 proceeding does not specifically
314 mention local gas, neither did the 1997 agreement. In fact, the closest either
315 GSA comes to referring to local gas was the 2003 agreement's reference to Part
316 530. As such, it is not clear why Consumers' interpretation of the purpose of the
317 GSA changed.

318 However, Consumers' change in its interpretation of the GSA conveniently
319 provided Consumers' affiliate Egyptian with the opportunity to profit from its gas
320 sales to Consumers.

321 Q. If you assume the GSA provided Consumers with the ability to enter into a
322 hedging transaction with Egyptian, did the hedging transaction follow the terms
323 of the GSA?

324 A. No. In my non-legal opinion, Consumers did not follow the pricing provision
325 associated with the GSA in its hedging transaction. I have copied Article IV -
326 Price, Section 4.1 from the GSA below.

327 **4.1** The term “delivered price” as used herein shall mean that price
328 paid by Buyer to Seller for natural gas delivered at Buyer’s gate.
329 The delivered price for natural gas sold and delivered pursuant to
330 this Gas Sales Agreement shall be as follows:

331 Gas will be priced \$0.05MMBTU less than the gas purchased from
332 Buyer’s primary gas source, J.D. Woodward Marketing or other gas
333 supplier, PLUS the transportation charges equal to the amount charged
334 by TETCO to transport gas to the delivery point. (Docket No. 03-0349,
335 Petitioners Exhibit CAR B-Revised)

336 While I am not an attorney, my non-legal opinion is that Consumers and
337 Egyptian did not follow the pricing provision of the GSA for the hedging
338 transaction. Consumers agreed in May 2006 to purchase certain volumes of gas
339 from Egyptian for delivery in January, February, and March 2007 (aka the
340 hedging transactions). My understanding of how Egyptian priced the gas it sold
341 to Consumers in January, February and March 2007, was to begin with the price
342 that was agreed upon in May 2006, subtract 5¢, and then add in the
343 transportation costs from its gas supplier for gas delivered in January, February,
344 and March 2007, respectively. However, the agreed upon price was not based
345 on any actual gas purchases or even any offered gas prices since Consumers
346 did not solicit any alternative suppliers when it decided to enter into the hedging
347 transaction with Egyptian.

348 **Conflict of Interest**

349 Q. Is there a conflict of interest when Consumers and Egyptian engage in gas
350 transactions?

351 A. Yes. In response to Staff DRs ENG 1.57 and ENG 1.58, in Docket No. 06-0744,
352 Consumers stated that C.A. Robinson was the President and CEO of both
353 Consumers and Egyptian during the 2006 reconciliation period, which is when it
354 entered into the hedging transactions. I maintain that as President and CEO of
355 both Companies, Mr. C.A. Robinson faced an inherent conflict of interest on
356 every occasion where business decisions were made regarding transactions
357 between Consumers and Egyptian.

358 Of particular concern to me is that Mr. C.A. Robinson can lower the business risk
359 for the unregulated affiliate Egyptian by pushing that risk onto regulated
360 Consumers. This occurs because regulated Consumers can recover its costs
361 from ratepayers, subject to prudence, while Egyptian as an unregulated
362 Company does not have that recourse. Mr. C.A. Robinson had the opportunity
363 to choose how to allocate profits and business risks in transactions between
364 Consumers and Egyptian. The transactions between Consumers and Egyptian
365 are not true "arms length" business transactions between independent parties.

366 I also note that the Commission's Order dated February 3, 2009, in Docket No.
367 05-0741 (page 4), Consumers' PGA reconciliation for 2005, quotes Mr. C.A.
368 Robinson's statement from the evidentiary hearing in that proceeding that "...his
369 role as President of Consumers Gas is to provide gas service at the lowest
370 possible cost to the customer." The Commission's Order also notes that,
371 conversely, Mr. C.A. Robinson later testified that as President of Egyptian Gas
372 Storage Corporation, his role is to maximize profits for the Company.

373 Of course, I agree with Mr. C.A. Robinson's responses. In fact, I consider that
374 these responses demonstrate the inherent conflict Mr. C.A. Robinson faced
375 when making business decisions involving transactions between Consumers and
376 Egyptian.

377 Q. How did Mr. C.A. Robinson acquire the gas that he used for the supply that
378 consummated the 2006/2007 hedging transactions between Consumers and
379 Egyptian?

380 A. In response to Staff DR ENG 1.65 from Docket No. 06-0744, Mr. C.A. Robinson
381 stated that Egyptian did not purchase any natural gas to fulfill its hedging
382 transaction with Consumers and that Egyptian held sufficient natural gas in the
383 Egyptian storage field to fulfill the hedge transaction. He stated that the Egyptian
384 storage field had 150,010 Dth in inventory at the beginning of 2006. In response
385 to Staff DRs ENG 1.63 and 1.64 from Docket No. 06-0744, Mr. C.A. Robinson
386 noted that the volume of gas associated with the hedging transactions were
387 31,000 Dth (December 2006), 30,000 Dth (January 2007), 31,000 Dth (February
388 2007), and 15,000 Dth (March 2007), which total 107,000 Dth. Therefore, I
389 agree that Egyptian had sufficient gas in storage to perform the hedging
390 transaction with Consumers.

391 Q. What was the value of Egyptian's 150,010 Dth of storage inventory at the
392 beginning of the 2006 reconciliation period?

393 A. In response to Staff DR ENG 1.65 from Docket No. 06-0744, Mr. C.A. Robinson
394 noted that the 150,010 Dth of storage inventory had a value of \$602,230.96.

Therefore, on average, Egyptian's storage inventory had a per unit value of \$4.01/Dth (\$602,230.96/150,010).

Q. What is the significance of the value of Egyptian's storage inventory for the hedging transaction between Consumers and Egyptian?

A. My concern is that the margin that Egyptian could achieve with the hedging transaction influenced the timing and the need for the transaction activity. As Table 1 below shows, the total potential margin for Egyptian on the 2006/2007 hedging transaction was approximately \$735,000.

Table 1

Delivery Month	Volume	Hedge Price \$/Dth	Inventory Cost \$/Dth	Margin \$/Dth	Margin \$
December 2006	31,000	11.06	4.01	7.05	218,550
January 2007	30,000	11.46	4.01	7.45	223,500
February 2007	31,000	10.55	4.01	6.54	202,740
March 2007	15,000	10.07	4.01	6.06	90,900
Total	107,000				735,690

Source: Consumers' Responses to Staff DRs ENG 1.63, 1.64 and 1.65 and DGK 7.01/7.02 from Docket No. 06-0744 and ENG 1.47 from Docket No. 07-0570

Q. Does the margin of \$735,690 represent the profit to Egyptian from its hedging transactions with its affiliate Consumers?

408 A. No. Table 1 merely shows the spread between the average inventory cost of
409 gas in the Egyptian field and the price of the gas that Egyptian must deliver to
410 Consumers. Since my understanding is that Egyptian accounts for the storage
411 inventory by layers based on the time of injection, I would need detailed
412 information about Egyptian's storage methodology to make a profit calculation.
413 For example, I would require knowledge on which gas layer the company
414 assigned to the gas sale, the price of that gas layer, what transactions costs the
415 company incurred, etc. However, I would note that this margin does likely
416 represent the general magnitude of Egyptian's profit from this transaction.

417 As such, Table 1 demonstrates the information that Mr. C.A. Robinson had
418 available at the time he made his decision for Consumers to enter into the
419 hedging transaction with Egyptian. This is important because my evaluation of
420 the prudence of a decision is dependent on what the decision maker knew, or
421 should have known, at the time the decision was made. As such, when
422 Mr. C.A. Robinson, as President of Egyptian, was executing the hedging
423 transactions with Consumers, he knew the transactions had a margin, as well as
424 a general magnitude of profit of \$735,690 for Egyptian.

425 Q. Did the 2006/2007 hedging transactions between Consumers and Egyptian
426 reduce Egyptian's business risk?

427 A. Yes. When Egyptian entered into these transactions, Mr. C.A. Robinson knew
428 Egyptian had sufficient inventory to perform the 2006/2007 hedging transactions
429 with Consumers at a potential margin of \$735,690. Since Mr. C. A. Robinson

430 controls both sides of the transaction between Consumers and Egyptian, there is
431 virtually no business risk for Egyptian. The potential to shift profits to an
432 unregulated business from a regulated utility is undeniable.

433 Q. Do you have any other area of concern regarding the relationship between
434 Consumers and Egyptian?

435 A. As I noted in my direct testimony from Docket No. 06-0744, Consumers 2006
436 PGA proceeding, (ICC Staff Exhibit 4.0, pp. 18-19), the percentage of Egyptian's
437 total sales to Consumers has steadily risen such that in 2006, Consumers was
438 responsible for 100% of Egyptian's sales in 2006 (versus 53% in 2004, and 99%
439 in 2005). The Company's response to Staff data request ENG 1.61 showed
440 Consumers continued to account for 100% of Egyptian's sales in 2007.

441 My concern is that since Consumers' gas costs are a direct pass through to
442 ratepayers, unless the Commission disallows imprudent gas costs, there will be
443 an incentive to maximize Egyptian's profits via transactions between Consumers
444 and Egyptian.

445 Q. Please summarize why an inherent conflict of interest exists between
446 Consumers and Egyptian.

447 A. As President and CEO of Consumers, Mr. C.A. Robinson stated his role is to
448 provide gas service at the lowest possible cost. As President and CEO of
449 Consumers, he decides on the timing of the hedge transaction and on which
450 entity to select for the transaction. As discussed by Staff witness Rearden, the

451 timing and rationale of Consumers' hedging was imprudent. Mr. C.A. Robinson
452 also did not seek competitive bids for Consumers' hedges or consider any
453 alternatives to his affiliate Egyptian. Further, Consumers was the customer for
454 all of Egyptian's sales in 2006 as well as 2007, and that increases Mr. C.A.
455 Robinson's incentive to shift costs to Consumers and profits to Egyptian.

456 As President and CEO of Egyptian, Mr. C.A. Robinson did not face any risk in
457 this transaction, since he had the gas for the hedge transactions already in
458 inventory in the Egyptian field at a known price. In addition, Egyptian could
459 easily execute the hedge transaction because its storage field is integrated into
460 Consumers' supply system.

461 In summary, Mr. C.A. Robinson as President and CEO of Consumers decides
462 the timing of the hedge, and Mr. C.A. Robinson as President and CEO of
463 Egyptian knows the profit that Egyptian can realize from the transaction using
464 that timing. This is not a true "arms length" business transaction between
465 independent parties. The opportunity to shift costs to a regulated utility and
466 profits to an unregulated business are obvious. The inherent conflict in this
467 transaction is self-evident and obviously shifts costs to the regulated utility and
468 consequently, profits to the unregulated business.

469 Q. Does Mr. C.A. Robinson as President and CEO of Consumers claim Consumers'
470 ratepayers benefited from the hedging transaction with Egyptian?

471 A. Yes. In response to Staff DR ENG 1.61 from Docket No. 06-0744, Mr. C.A.
472 Robinson states "Consumers chose to hedge with Egyptian as the gas was

473 cheaper and was also deliverable as it was already in the Mills Gas Storage
474 Field.”

475 Q. Do you agree with Mr. C.A. Robinson’s statement?

476 A. No. As discussed in Dr. Rearden’s testimony, the hedging transaction was
477 imprudent because it raised gas costs above what was available to Consumers.
478 In fact, the only claim that Mr. C.A. Robinson can make for ratepayer savings is
479 the pricing provision in Consumers’ contract with its affiliate Egyptian, which
480 allows Consumers to purchase gas at \$0.05/Dth below Consumers’ contractual
481 supplier’s price.

482 However, it appears to Staff that the likely impetus for this transaction was a
483 benefit to Egyptian - not ratepayers. The total volume of the hedging transaction
484 between Consumers and Egyptian was 107,000 Dth. Assuming Consumers’
485 activity truly saved ratepayers \$0.05/Dth, then the hedging transactions resulted
486 in a total savings of \$5,350 ($\$0.05/\text{Dth} \times 107,000 \text{ Dth} = \$5,350$) for ratepayers.

487 The benefits to Egyptian are more substantial. As noted in Table 1 above, the
488 hedging activity resulted in a margin for Egyptian equal to \$735,690. These
489 amounts are more than sufficient to show the inherent conflict of interest that Mr.
490 C.A. Robinson faced when he entered into these transactions. It appears likely
491 that this transaction was motivated less by the potential for ratepayer savings
492 equal to \$5,350 than unregulated Egyptian’s margin of \$735,690.

493 **Conclusion**

494 Q. What conclusions have you reached based upon the above analysis?

495 A. The original purpose of the GSA between Consumers and Egyptian was for the
496 purchase of local gas production, a fact that Consumers does not dispute.
497 Further, I established that at no time was a hedging transaction discussed when
498 Consumers requested Commission approval of the GSA. Therefore, the
499 Company's reliance on the GSA as the basis for the hedging transaction is
500 inappropriate.

501 Q. Are you providing the prudence disallowance associated with the hedging
502 transaction?

503 A. No. It is my understanding that Staff witness David Rearden, ICC Staff Exhibit
504 3.0, is providing the calculation associated with the Staff's conclusion that
505 Consumers' hedging activity with its affiliate was imprudent.

506 Q. Does this conclude your prepared direct testimony?

507 A. Yes.